

REVIEW OF THE ROLE AND EFFECTIVENESS OF NON-EXECUTIVE DIRECTORS – ABI RESPONSE TO CONSULTATION PAPER FROM DEREK HIGGS

INTRODUCTION

- 1.1 On 7 June 2002, Mr Derek Higgs issued the consultation paper taking forward his review of the role and effectiveness of non-executive directors.
- 1.2 This document is the response of the Association of British Insurers whose 400 members, as institutional investors, have around £1,000 billion of funds under management including around £350 billion in the equity shares of UK-listed companies. They therefore have a keen interest in promoting effective governance in the companies in which, on behalf of policyholders and other beneficiaries of their funds, they invest. In addition, they are themselves companies, whether mutual or proprietary, and accordingly are concerned from this perspective to ensure well-functioning arrangements in the boardroom.

GENERAL COMMENTS

- 2.1 Recent events in the US corporate sector have made the review of the role of non-executive directors (NEDs) topical and timely. The ABI has always believed that the fundamental objective of corporate governance is to ensure the existence of appropriate checks and balances without stifling entrepreneurial flair. We consider that the UK system works effectively, and it compares well on an international perspective. Nevertheless, useful evolutionary reform should be encouraged and the best practice framework developed where appropriate. The development of the senior independent NED role, formally recognised by the Hampel Committee's review of corporate governance, is a good example of such development in recent times.
- 2.2 An important strength of the UK system is the focus on principles over rules and on substance over form. It is right that the Review, while avoiding in-depth reconsideration of matters where consensus of opinion firmly supports current arrangements, should consider matters from a principled basis.
- 2.3 The Review is being undertaken alongside other projects such as the development of a new Companies Act and the Ministerial Review of accounting and auditing matters. We will be responding to opportunities to comment in relation to these but with obvious overlaps

of coverage it will be important that consistency of thinking informs ultimate decision-making and that the right balance is maintained between regulation and the consensual implementation of best practice. Not only must the right structures be in place; effort and resources must also be focused on making them work effectively.

- 2.4 The Government has also announced its intention to legislate on shareholder activism. We have expressed reservations regarding this project but we would signal in the context of the Review that activism by shareholders, in order to be constructive, also requires effective independent directors with whom to engage.
- 2.5 The role of NEDs is increasingly recognised to be vital for proper governance and direction of listed companies. They should bring probity, independence and outside expertise to the company, and they should assist in decision-making while ensuring accountability. Collectively they have roles to play in people judgment, succession planning, systems and strategy. NEDs also need to ensure that the right processes exist for the governance and control of the company and that these are followed.
- 2.6 The work of the board, which is essentially high level, is distinct from executive duties of the CEO and his senior management team, which should be carried out outside the boardroom. NEDs do not have executive responsibilities within companies or access to as much information as full-time executives and it is important that NEDs are provided with all necessary relevant information for topics that the board is expected to consider. Although NEDs have roles to play on unitary boards that are complementary to those of the executive directors, it should be emphasised that all the directors, including both executives and NEDs, are responsible for the decisions of the Board.
- 2.7 Directors are given responsibilities on behalf of shareholders and it is right that they, not shareholders, should be responsible for discharging the duties that follow. However, directors are accountable to the shareholders for this stewardship function and communication between NEDs and shareholders should be an important theme. Such communication should not be overly-formalised as would be likely through an annual meeting format as suggested by Paul Myners in his review of institutional investment, though there would be merit in ensuring some structure to the contact, for example through NEDs attending some meetings between major shareholders and executives.
- 2.8 It is also important to avoid creating a perception that there are two classes of shareholder – those with access to NEDs and those without – just as it is important to recognise that there are not two classes of director: executive and non-executive directors are equally accountable to shareholders and channels of dialogue need to take account of this. Contact with shareholders should be about enabling

directors to carry out their duties effectively and to understand the expectations of major shareholders and of the investment markets.

- 2.9 Increased expectations on NEDs make it all the more important that the talent pool of potential NEDs with appropriate skills and expertise is properly exploited. It is also suggested by many well-placed observers that levels of remuneration of NEDs in the UK are not high enough for the role that they play. As expectations and potential liabilities rise there needs to be commensurate increase in reward in order to maintain the right balance.
- 2.10 Some increase in fees payable per company per individual NED could be justified given the importance of what is expected of them. Individuals holding fewer non-executive directorships but being better remunerated for those they do hold could lead to more effective performance. However, with greater expectations of NEDs it becomes ever more important that proper procedures for board evaluation exist and that the justification for potentially increasing monetary reward is properly assessed.

SPECIFIC COMMENTS

A: Role

What role should non-executive directors perform, and how does this compare to the present position?

Q1 What is the role of the board? What is the role of the Chairman and how does it relate to the non-executive directors?

The role of the board is conceptually distinct from that of the executive management. The board, elected by shareholders, is responsible for running the company while executive management is responsible for running the company's business and it is accountable to the board in respect of this. The Chairman's role, in the first instance, is to manage the board though this may extend into a wider focal leadership role. The Chairman also has in many cases an important external role to play and this should include relationships with major shareholders.

Q2 What should be the key roles of non-executive directors on the board and what should be the balance between the different components? Within a board, should all non-executive directors be expected to fulfil each of the different roles?

Non-executive directors broaden the base of experience within the board, can be a valuable source of external expertise to the company,

and bring qualities of independence to bear. Their allocated roles should be such as to make use of these qualities and to ensure that good governance by the Board is not impaired through possible conflicts of interest. Not all non-executive directors need to fulfil each of these conceptually different roles. What is important is that the body of non-executive directors does so and that the required mix of skills is accessible.

Q3 How does this compare to the present position?

This varies from company to company. Where problems have arisen, weaknesses of NEDs, as well as of executive directors, have often been a contributory cause.

Q4 How independent do non-executive directors need to be for the different roles?

Different qualities of independence are appropriate for these different roles which NEDs are expected to play. This means that an undue focus on pre-determined definitions of independence for all purposes is not always helpful. Different criteria may be appropriate in judging the appropriateness of particular NEDs sitting on the Remuneration and the Audit Committees. Overall qualities of independence, as much as the status of individuals, will be a key determinant of the effectiveness of board committees.

Q5 What are the main potential conflicts of interest which may arise within a company where non-executive directors can play a role in protecting the interests of the company? What can be done to help non-executive directors to be effective in relation to these conflicts?

The main potential conflicts of interest will tend to relate to matters which, broadly, are within the scope of the Remuneration and the Audit Committees. NEDs need to recognise that potential conflicts exist and, where required, they need to be robust in ensuring these are managed in a manner which best serves the interests of the company. On occasions, it may be appropriate for them to discuss problems with major shareholders. This will be the exception rather than the norm but it is essential that NEDs recognise their obligation to do so on such occasions and that they have the ability to initiate such contacts.

Q6 What time commitment is needed for the role of Chairman and for non-executive director roles, and how far does this vary between different companies? Are there any implications for the number of non-executive posts that one person can sensibly take on?

The time commitment required of the Chairman is likely to be significantly greater than for the other non-executive directors in the company. Relative remuneration levels for non-executive or part time Chairman, and NEDs, already recognise this.

In practice, the time that NEDs will be obliged to commit will vary according to the circumstances of the company. However, there must be realistic constraints on the number of positions that an individual can reasonably take on. This will vary according to the individual and his/her circumstances and we do not believe that to apply a prescriptive limit would be helpful. Where an individual holds a position of Chairman of a company, this represents a very significant potential time commitment and will significantly reduce the number of other directorships that can prudently be taken on. It is unlikely that they will be able to discharge this role as well as that of a full-time executive position elsewhere. Where the individual holds a full time executive position, it is unlikely that they will be able to spare the necessary time for more than one outside non-executive directorship. Nomination committees should properly consider this when putting candidates forward. Shareholders should not be expected to support the election of NEDs who would not be in a position to provide appropriate time commitment to the role.

Q7 *Should there be a special role for a “senior independent” non-executive director?*

We believe the role of senior independent non-executive director to be an important one and we believe all listed companies should, as the Hampel Report recommended, designate such an individual. The precise nature of the role may well vary somewhat from company to company, for example being a more important role where there is an executive chairman in situ. There is a need for the additional check and balance which the senior independent NED role embodies.

The senior independent NED can have a particularly important role to play in particular circumstances, such as where consideration is being given to the chief executive vacating that office and assuming the chairmanship. Institutional shareholders do not generally welcome chief executives succeeding to the chairmanship but where this in prospect it is vital that the decision is robustly scrutinised by the independent directors and that there is a focal point of leadership exists for the purpose.

It is important that the senior independent NED be given appropriate support to carry out the role effectively and that unreasonable demands are not made on individuals who, by the very nature of the role, should be genuinely independent and non-executive.

Q8 *Do you have comments on the proposed statutory statement of directors' duties, which does not seek to distinguish between the legal duties of executive and non-executive directors?*

It is right that legal duties of directors apply to the whole Board and all its members. It is, however, important to recognise that Board members play complementary roles. We understand the intention behind the company law proposals is to recognise that there is a balance to be achieved between recognition of different roles, while avoiding detracting from overall responsibilities of the unitary board. 'Duties of directors' is a central aspect of the company law framework and it will be important to ensure that statutory codification as proposed in the White Paper does not lead to inadvertent changes in the legal position as it is currently understood.

B: Attracting and appointing non-executives

What knowledge, skills and attributes are needed, and what can be done to attract, recruit and appoint the best people to non-executive roles?

Q9 *What are the key skills, knowledge and experience which are needed by non-executive directors to perform the role effectively, and how is this likely to change over the next, say, 10 years? Are some skills essential and, if so, what are they?*

A range of skills, knowledge and experience are desirable in NEDs in order that they can perform their roles effectively but these need not all be equally developed in all fellow directors on the board. Experience of management and board functions in other large listed companies, particularly strategic and financial knowledge, help, but wider experience by some directors of other environments and professional disciplines can bring valuable perspectives to bear. The ability to question, seek out and evaluate information and to test management's strategy is essential to robust decision-taking and the sound direction of the company. Independence of mind is required rather than uncritical support and a preparedness to confirm received wisdom.

Q10 *What personal qualities and attributes are needed?*

Probity, diligence, independence of mind-set tempered by ability to operate within the collegiate structure of the unitary board, are essential. NEDs must pull their weight and be prepared to be proactive and be prepared to devote additional time to the role in circumstances that require it.

Q11 What sort of mix of experience and attributes is desirable on a Board? Specific examples of cases where non-executive directors have contributed with particular effect to company performance, or to corporate governance, would be helpful.

See our answer to Question 9.

Q12 How easy is it to recruit non-executive directors with the right skills and attributes? Could recruitment and appointment mechanisms, including Nomination Committees, be improved?

Some expansion of the role of Nomination Committees in giving proper consideration to recruitment of NEDs with the right skills and attributes and in ensuring overall balance of the board could be well worthwhile. It is important that NEDs bring skills which are relevant to the company's needs as a commercial entity, but nomination committees need to be open-minded in where to find them.

Q13 What could be done to widen the pool of potential non-executive directors and introduce greater diversity into appointments? What are the constraints on this? Is there scope for greater international representation on UK boards?

We concur with the view that the pool of potential non-executive directors should not be allowed to be a narrow one as we believe that diversity of abilities and perspectives is of value. Whether greater international representation would be a desirable feature will vary from company to company. Some UK companies already have a wide spread of representatives. However, where board members are very dispersed geographically, this will not always assist cohesiveness of boards and ability to act promptly when circumstances require it and it may also have implications as regards accessibility to shareholders. Internationalisation is not helpful in its own right.

Q14 Are the rewards for non-executive directors appropriate, both in terms of levels of pay and the form that remuneration takes – e.g. cash/shares/share options? Are current pay levels a significant factor in whether good non-executive directors can be attracted?

We believe rewards for non-executive directors need to be appropriate to the role and responsibility, the potential time commitment and potential liabilities. Good NEDs are a valuable resource to companies, which should not be afraid to pay the appropriate rate. This payment may take the form of either cash or shares in the company but we are strongly opposed to the concept of awarding share options to NEDs as it is essential that NEDs take a balanced view of all decisions impacting on the company's development. It is also important that independence

of NEDs is not compromised through their participation in incentive schemes or through the provision of inappropriate benefits.

Q15 *Do you have comments on the issue of risks or insurance provision for non-executive directors?*

There is a perception that the risks attaching to being a NED of a UK-listed company have risen in recent years. This may reflect in part a better understanding of the reality of responsibilities assumed by directors. More materially it reflects greater expectations on company directors from various sources, and the possible legal consequences in the event of corporate failure. As expectations and litigation risk rise so, inevitably, does the corresponding cost of securing the services of NEDs. This must be met through either higher fees payable to NEDs or increasing costs of insurance, or through both.

Against this backdrop, our understanding of the market for D&O insurance is that it continues to work effectively. As claims experience has deteriorated this has led to some upward pressure on premiums to balance increased underwriting risk. D&O liability insurance cover may therefore not be available at the same price as hitherto but we see no evidence of reduced market capacity for the underwriting of such risks.

Shareholders are not generally privy to information as regards costs of such insurance being met out of company resources though it might be thought appropriate on governance grounds that they should.

C: Structures and accountability

Do existing structures and procedures facilitate effective performance by non-executive directors?

Q16 *How is the Combined Code working in practice? In particular, how are the provisions on the balance between executive and non-executive directors and the role of independent non-executive directors working? Is further definition needed of independence in the Combined Code and, if so, what would a sensible definition be?*

We believe the Combined Code, and the requirements for companies to comply or disclose reasons for non-compliance, work reasonably well. There has been a steady uptrend in the proportion of companies demonstrating full compliance with one third of companies reporting in the second quarter of 2002 achieving full compliance. Rates of compliance with specific aspects of the Code run generally at much higher levels, again with improving trends. As compliance rates rise so does the onus on those companies that fail to do so, to justify the reasons for this to their shareholders.

We see no compelling reason to require a change in the balance between executive and non-executive directors, or between independent and non-independent directors. There will be difficulties in devising a clearer definition for Combined Code purposes of the status of independence for NEDs that will be genuinely appropriate in all circumstances. The ABI, in common with the NAPF, has established a working benchmark of independence that can be used for comparative assessment between companies. ABI would expect to give consideration in due course as to whether this benchmark remains appropriate.

Q17 Do the recommended structures for board committees facilitate governance and an effective contribution by non-executive directors? Are board meeting procedures working effectively? Do you have comments on board size?

The currently recommended structures for board committees do, we believe, facilitate good governance and effective contributions by NEDs. However, the role of the Nomination Committee is in many companies insufficiently well developed. As regards minimum size of boards, the Cadbury Report of 1992 established well-judged guidelines as regards minimum number of NEDs from which in practice follows an effective minimum size for the board as a whole.

It is important that companies avoid expansion of their boards to a size which detracts from effective decision-taking. The optimum size will vary from company to company and for large companies with varied operations and global scope, relatively large board size may be inescapable. A minority of companies have allowed their boards to remain too large, often as a result of acquisitions and mergers.

Q18 Do you have comments on the composition and duties of Audit Committees? How effectively are Audit Committees working in practice? Do you see a need to strengthen the existing Combined Code provisions on Audit Committees?

The Combined Code provisions regarding remuneration committee composition, in particular as regards the independence of directors sitting on such committees, go further than do those applicable to audit committees. This is an imbalance that is likely to be addressed as part of the Government's current Review of Accounting and Auditing Matters, to which we intend also to contribute in due course.

The importance of qualities of independence of Audit Committee members is at least as great as for the Remuneration Committee. Individuals on the Audit Committee should be financially literate but should not be required to be qualified accountants. We would

emphasise, however, that it is the overall qualities of independence of the Committee rather than an ability merely to 'tick the box' in respect of individuals, which is vital.

We are broadly supportive of the other provisional conclusions of the ministerial review of auditing and accounting matters, which advocate an expansion in the duties of the Audit Committee to include, *inter alia*, oversight of the appointment of the auditors. We consider it appropriate that the Audit Committee be responsible for making the appropriate recommendation to the Board. However, it is the Board that should be responsible for proposing the resolution for appointing the auditors on which shareholders are then asked to vote.

Q19 Similarly, do you have comments on the composition, duties or operation in practice of Nomination and Remuneration Committees?

Nomination and Remuneration Committees should fulfil an important function on PLC Boards. We would highlight the importance of their roles as regards recruitment and incentivisation of directors and other senior executives and it is important that they work together in this sphere. One of the greatest concerns in corporate governance relates to payment for failure to departing the executive directors in the event of early termination of their contract. It is clear that the potential for such payments arises at the time the contracts are entered into and it is important that the Nomination and Remuneration Committees jointly have oversight of the full process of recruitment. Remuneration Committees have a key responsibility in the event of severance where it is essential that they are robust in ensuring that terms agreed between the company and the departing executives are in the interests of the company and its shareholders and not merely based on a least resistance approach.

Q20 What processes are in place for setting objectives and reviewing performance against those objectives, for the board as a whole and for individual directors?,

Q21 Could more be done to review performance? Should more information on board performance be reported to shareholders? Should companies provide more information on the performance of non-executive directors?,

Board evaluation, preferably through an externally validated process, is important but this does not extend to a requirement for public disclosure of individual performance. Good processes will protect the company and its board where there are difficulties. One useful indicator of commitment by directors is their board and committee attendance record and information regarding this could also usefully be made available to shareholders.

Q22 *Are non-executive directors able successfully to challenge executive decisions or expose serious problems? Should it be made easier for them to do so and, if so, how?*

They must be able to do so but they are not an opposition to the executive directors on the board. Where appropriate they must be prepared to discuss matters with shareholders. It is essential that NEDs have access to sufficient information for them to be able to make informed decisions and that they do not approve matters where they are not in an informed position. Where necessary they should take time and/or be prepared and be able to obtain independent advice or comfort.

D: Relationships with shareholders and others

Do existing relationships with shareholders or others need to be strengthened?

Q23 *How well do relationships between non-executive directors and shareholders and stakeholders work, and could they be improved? For example, we would be interested to hear views on what the relationship might be between non-executive directors and institutional shareholders. How could this relationship be strengthened?*

The relationship between non-executive directors and institutional shareholders is a very important one. It is a relationship which might usefully be strengthened in substance though we are not inclined to the view that this would be best achieved through overly formalised arrangements such as an annual meeting between the two sides. Rather, it would be beneficial if NEDs were to be sufficiently involved in the regular contact between management and shareholders to be sure that they are aware of shareholder views.

Where shareholders initiate dialogue with companies on specific issues, it will often be appropriate that the senior independent NED, or where relevant the independent director chairing the Audit or the Remuneration Committee as appropriate, should also be involved. On other occasions, dialogue specifically with such NEDs may be the appropriate course.

The board of the company is responsible for relationships with “stakeholders” but they are accountable to shareholders. It is therefore appropriate that NEDs, in order to understand the business and its needs, should consider whether and to what extent contact with relevant interested parties would be appropriate. They do not, though, have responsibilities to those “stakeholders” any more than the

company and its board do. How the company manages its relations with customers, suppliers, employees and wider interests is nevertheless of obvious importance.

Q24 To what extent are Chairmen creating the conditions for non-executive directors to be effective? Is there more that they could do, by promoting constructive relationships, managing the discussion processes, encouraging challenging and effective contributions in board meetings and ensuring appropriate information flows, or otherwise?

An effective Chairman will do this whilst an ineffective one (whether because he is overbearing himself or allows the chief executive or other executive board members to be so) will not. Board evaluation should help to identify where NEDs are not enabled to be effective.

Q25 What should be the relationship between non-executive directors and executive directors, and with senior management? What should their relationship be with the Chairman and the Chief Executive? What should their relationship be with key advisors to the company?

It is appropriate that contact between NEDs and the executive directors and other senior management is not restricted merely to their discussions and deliberations within the structure of board meetings. The Remuneration Committee should also have contact with the remuneration advisers, if any, employed by the company, though in many cases the Remuneration Committee itself may wish to appoint advisers.

Q26 How can Company Secretaries support effective performance by non-executive directors?

The importance of the role of the Company Secretary in the governance framework for companies should not be underestimated. The Company Secretary's primary responsibility is in respect of the board of the company and its members rather than the company's business and thus its executive management. It is vital that the relationship between the Company Secretary and the NEDs, equally as with the executive directors, is an effective and uncompromised one.

E: Support

How can non-executive directors best be supported to perform their role?

Q27 How much access to information from management do non-executive directors need to be effective? In practice, are information flows and communication channels sufficiently open and unrestricted?

Non-executive directors should be provided with all the information from management that is necessary in order for them to do their job effectively. Where relevant, NEDs should have the ability to take independent advice. Where information has not been made available or not in readily utilisable form, the non-executive directors should insist that such information be provided to them in an appropriate form. Where the NEDs are being deprived of the information necessary for them to fulfil their role they need to take all possible action to remedy this situation but if this cannot be resolved they should be prepared to resign or bring the matter to the attention of shareholders.

Q28 What training and developments opportunities are available? Could they be improved and, if so, how?

Q29 Can induction for non-executive directors be improved?

This is probably the case but this need not necessarily involve significant additional time commitment. Boards should ensure that their procedures are tailored to their requirements.

Q30 Do non-executive directors get clear guidance on what is expected of them and do they get feedback on whether they are meeting expectations?

Companies that do not already do so could usefully consider developing appropriate guidance in written form that encapsulates what is expected of their directors. Company-specific guidance is of course additional to duties applicable to all directors under the law with which they should also be properly conversant. As regards meeting expectations, we would refer to our earlier comments in support of board evaluation.

F: Smaller listed companies

In what ways is the position different for smaller listed companies?

Q31 To what extent do different factors apply in the case of smaller listed companies? Is different provision necessary?

We consider that principles of governance are applicable to all listed companies though full practical compliance may be more difficult to achieve for small listed companies. This is the approach by which ABI

and its members would seek to assess compliance with acknowledged best practice by the companies in which they invest.

G: International context

What can we learn from international experience?

- Q32 *What lessons can be learnt from international experience, either in terms of structures or behaviours?,*
- Q33 *Do other models of corporate governance or different boardroom roles or dynamics contribute more to company performance?,*
- Q34 *Would it be beneficial to bring UK practice more in line with that in any other countries? If so, why and how?*

We consider that UK board structure and models of corporate governance work as well as any internationally, if not better. The UK's unitary board system, with an appropriate balance of executive and non-executive representation, differs very materially from the two-tier board structure applicable in most Continental European countries though it is also the case that US practice, otherwise more similar to that of the UK, does not fully accord because of the generally limited level of executive representation on US boards.

Optimal structures will vary from country to country reflecting different cultural aspects as well as different legal arrangements. However, principles should be universally applicable and it is important to be aware of progress in other jurisdictions, and to incorporate approaches that might further enhance UK practice.

10/09/02

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